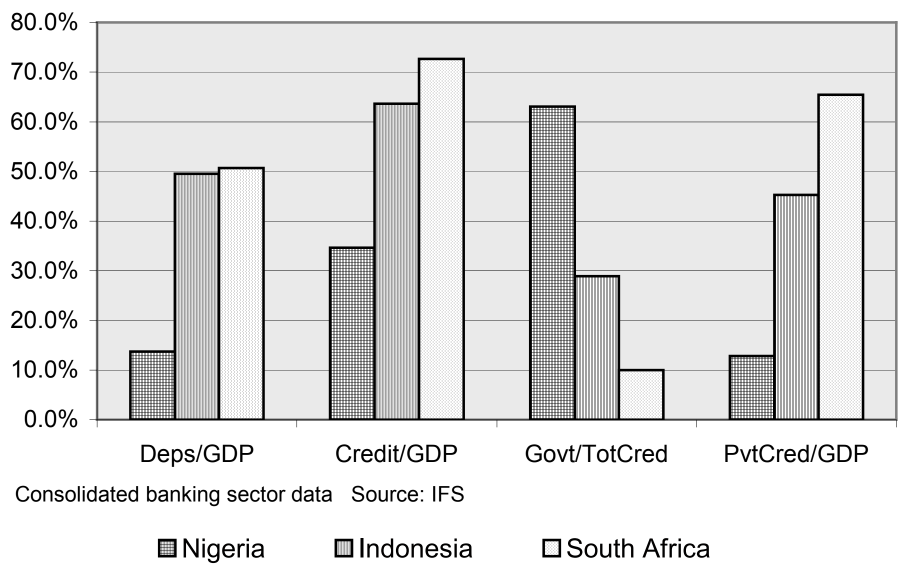
Nigeria Financial Sector Assessment

Introduction and Executive Summary

Nigeria's financial sector must greatly expand if it is to enable the nation's desperately needed economic growth. Presently, as indicated by Figure 1 below, the Nigerian financial sector falls far short of the performance of countries to which Nigeria would like to become comparable. Its ratio of bank deposits to GDP is only one-fifth that of Indonesia or South Africa, and it shows only about half as much outstanding credit relative to GDP.[1] Furthermore, of that outstanding credit, over sixty percent has gone to the government, versus thirty percent for Indonesia and just ten percent for South Africa. Putting these numbers together, the ratio of Nigeria's private sector credit outstanding to GDP is only about twelve percent – far below comparison countries. It must unfortunately be said that the Nigerian financial sector functions first and foremost as a channel for funding government debt. It is only secondarily a source of finance to the private business sector. This is of course the opposite of what is necessary for vibrant economic growth.

Figure 1: **Financial Development Indicators**
Annual Averages, Outstanding Balances, 1993-2001



[1] Nigeria is often compared to Indonesia because the two countries were in very similar positions thirty years ago when they started to become significant oil exporters. They started out with about the same level of GDP and broadly similar population sizes, and over the past thirty years they have earned about equal revenues from oil exports. However, Indonesia's GDP is now five times that of Nigeria, and its non-oil exports thirty times greater. Nigeria's GDP per capita is today virtually the same as it was thirty years ago, while Indonesia's has risen by 250%.

Meanwhile, Nigeria's financial sector attracts virtually no inward foreign portfolio investment – almost all foreign private inflows are in the form of contributions by large parent company multinationals directly to their subsidiaries, mainly in the oil sector. Nigeria's own institutional investors have quite limited investable surpluses, and the insurance and mortgage finance sectors are extremely small. Its development finance institutions (DFI's) are in disarray, and in any case offer an amount of capital that is minor relative to the normal need for concessional finance to support economic growth.

The Nigerian financial sector serves mainly larger, well-connected enterprises. Private small and medium-sized businesses (SMEs), though they generally do have access to bank loans, try as hard as they can to avoid borrowing, because the high level of interest rates is unaffordable relative to their mostly tight profit margins. While it is generally observed that the Nigerian financial sector provides little long-term lending, the fact is that most businesses have no desire for long-term indebtedness at the rates they would have to pay for it. Meanwhile, because Nigerian banking controls such a scarce but critical resource – the supply of domestic loanable funds – and need lend only to the most qualified borrowers, it is among the most profitable business segments in the country.

Estimating Credit Growth Needs

No economy can develop without credit. Without credit, investments must be self-financed out of saved earnings. This is in fact the principal source of productive finance in Nigeria. But building up capital in such a way is time-consuming and difficult, and postpones the demand for goods and employment that accompanies investment. Indeed, an economy in which self-financing predominates traps itself in a dynamic that widens stagnation and poverty. Without access to affordable credit, many are forced into low-investment activities like petty trading to earn money. The result is excessive competition in such activities, and profit margins that are so repressed that it is impossible for most sellers to earn much more than they need simply to feed themselves and their families – much less to borrow money at high interest rates. The failure to develop an expanding credit system does more than limit growth, it actually widens the incidence of poverty, aggravates the inequality of income distribution, and creates constant political pressure on government for it to be the employer of last resort. [2]

A simple but instructive economic model can be used to come up with broad targets for credit expansion in Nigeria. The results of this exercise are contained in the following table:

Table 1: **Estimating Private Sector Credit Growth Needs**		
	2003	**2010**
GDP / Capita *(USD)*	310	500
GDP *(billions of naira)*	5,990	11,670
Private Credit Flow / GDP	3.3%	4.7%
Total Private Credit / Yr *(billions of naira)*	200	550

As will be developed below, the present flow of credit to the private sector in Nigeria is about ₦ 200 billion ($1.5 billion) per year. This accommodates a present GDP level of

[2] Indeed, in Nigeria, over 50% of formal sector employment is in government.

some ₦ 6 trillion per year ($42 billion), which works out to about $310 per capita. A desirable target for growth over the next 5-7 years might be one which would raise per capital GDP by fifty percent, to $500 per year, or a total of GDP of ₦ 11-12 trillion ($75 billion), after providing for annual population growth of perhaps 2.5%.[3] However, according to this simple model, to enable such a GDP level an annual flow of credit to the private sector of some ₦ 550 billion ($3.8 billion) in 2010 would be required – almost three times the current rate.[4] Expressed another way, credit to the Nigerian private sector must *grow* by an average of ₦ 50 billion ($350 million) per year over the medium-term projection period.

This looms large relative to the recent experience of Nigerian credit markets. To be achieved in 2004, it would require an increase of one-third in bank credit to the private sector over the rate of recent years, or, alternatively, a doubling of new private sector issues on the capital markets. On the other hand, if we consider the amount of credit that is going to the government (₦ 250 billion per year), or is draining away in private capital flight (₦ 200 billion per year), then there do appear to be sources from which such private sector credit growth could be drawn.

Present Nigerian Financial Sector Capabilities

As is reviewed in considerable detail in the body of this report (and its separate technical background papers), the Nigerian financial sector does have a fairly developed institutional structure, and it is capable of reaching most potential borrowers. The banking system has a lengthy history, and includes a core group of about ten large and reasonably strong institutions. After a period of liberalization and rationalization in the late 90s, it has supplied an average of about ₦ 150 billion annually (about $1 billion) to the Nigerian private sector over the past four years. Furthermore, with a reasonably large branch network, all larger companies and most SMEs do have access to bank finance. Bank supervision has also improved and while there remain shortcomings, and some areas of systemic risk that need to be addressed, it is reasonably good by developing / transition country standards.[5]

Meanwhile, the capital market, consisting mainly of the Nigerian Stock Exchange (NSE), has shown rapid expansion in its absorption of new issues in recent years, providing some ₦ 50 billion ($350 million) to the private sector in 2002. The professional management of the exchange is competent, and its supervision under the SEC has improved. While IPOs are too rare, secondary trading is limited, and some undesirable practices remain to be rooted out, the NSE is basically sound and has modern automated systems. Investor protection has been enhanced by the recent establishment of the Investment and Securities Tribunal (IST). This market appears to deserve more attention from foreign financial investors than it is receiving.

Constraints to Private Sector Financial Expansion

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[3] This is slightly optimistic. Average population growth over 1993-2001 was 2.8% per annum.

[4] As seen in the table, we also assume that financial sector penetration would have to rise somewhat to enable economic expansion, from 3.3% of GDP to 4.7%, a level in the range of Indonesia's. But even if this ratio were unchanged, Nigeria would still need to generate ₦ 400 billion annually in credit to the private sector by 2010, double the current level, to achieve the targeted increase in GDP per capita.

[5] The recent IMF *Financial System Stability Assessment* of December 2002 provides a thorough review and evaluation of the quality of bank supervision in Nigeria.

The principal obstacles to the growth of finance to the private sector in Nigeria, despite this reasonably good basic institutional foundation, are as follows.

- *Excessive Government borrowing and spending.* Nigerian is enormously burdened by a long tradition of statist, rent-seeking government that is very difficult to reform from within, due to heavily vested interest,. In 2002 the expansion of government debt consumed well over half of total domestic credit expansion.
- *A limited and inelastic supply of credit*, caused by low domestic household sector incomes and wholesale avoidance of Nigeria by foreign financial investors, due to its extremely poor reputation for corruption and mismanagement. Even inflows from official development assistance are well below what they could be if Nigeria were willing to commit itself credibly and aggressively to reform.

Combining these two basic problems, interest rates faced by the private sector are extremely high. With government consuming over half of an already limited and inelastic supply of credit, the price of finance is excessive, probably about 25 percent per annum for the average company, versus an inflation rate in the 10-20 percent range. With profit margins in most businesses forced down by extreme competition, only those firms that must borrow do so (such as processors of primary agricultural commodities), and even they limit their use of credit as much as possible. The unwillingness of companies to borrow funds at these excessive real interest rate levels is a fundamental obstacle to the growth of Nigerian finance. It must be addressed for economic growth targets to have any chance of being met.

The principal means of addressing these basic obstacles, therefore, are first to radically improve management of public expenditure so as to drastically reduce the drainage of funds to the government, and second to seek to increase the supply of funds to Nigeria, mainly by attracting greater foreign sector finance.

There are two important secondary obstacles to Nigeria's financial expansion which can be drawn from the analysis contained in this assessment.

- *Nigeria's development finance institutions (DFIs) are extremely weak.* Some started out reasonably well years ago, but all have fallen on hard times in recent years due to the overall failure of the Nigerian economy. Nigerian DFIs hold only about one percent of total financial sector assets and show little growth. Yet Nigeria very much needs a reasonable supply of concessional development finance.
- *The "supply of paper" from the Nigerian private business sector to the financial sector is underdeveloped.* Despite viable business strategies and operations, many businesses are unwilling to come to the credit and capital markets because of a fear of revealing their financials, and others lack the professional capacity to present the clear business plans and financial reports that the organized financial sector needs. Meanwhile, especially in the severely underdeveloped agricultural sector, businesses lack the commercial viability required for formal finance. For their credit needs they rely primarily on informal intermediary systems which are not capable of supplying sizeable individual loans, and are not sophisticated enough to promote more commercial behavior.[6] This underlines the critical

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[6] Studies have found that informal lending institutions, while providing good coverage, are generally unable to provide the size of credits needed by viable growing micro and small

importance of complementary support for the development of a market-oriented, privately-led, commercially-empowered agricultural sector.

Recommendations for Intervention

These findings lead to recommended USAID activities to assist the development of Nigeria's financial sector in two areas.

1. Support for the development of a strong, quasi-commercial Nigerian DFI, complemented by the provision of credit enhancement to allow it to significantly expand the availability of concessional term lending to viable Nigerian private enterprises.
2. Support for the expansion of Nigerian capital markets, focused on the stock exchanges (the NSE and the emerging Abuja Stock Exchange), in two areas:
    - Capacity-building to improve the ability of capital markets professionals to attract viable companies to the market, to invest and manage private equity, and to improve the ability of borrowers professionally to present their business plans and financial results, possibly in combination with business development professionals.
    - Facilitation of the establishment of strong and sustained business linkages between the Nigerian exchanges and exchanges and institutional investors in major money centers, in order to attract foreign financial investment into professionally-operating Nigerian capital markets at a level that is consistent with their true risk-reward profile.

It is of overarching importance, given the excessive weight of government in the Nigerian financial sector, that USAID remain committed to complementary activities to support (1) improvement in the management of public expenditure, (2) improvement in the performance of the central bank and the money and capital markets in dealing with public debt, and (3) liberalization of economic policy and reduction of statism and corruption.

This summarizes the findings of this assessment. We now turn to in-depth review and analysis.

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businesses who cannot meet the information and collateral requirements of formal lenders. See Aryeetey et. al., *Financial Market Fragmentation and Reform in Sub-Saharan Africa*, World Bank Technical Papers, 1997.